

**DEPARTMENT OF STATE REVENUE**

**LETTER OF FINDINGS NUMBER: 00-0476  
Adjusted Gross and Supplemental Net Income Tax  
For The Years Ending 1997 and 1998**

NOTICE: Under IC 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of this document will provide the general public with information about the Department's official position concerning a specific issue.

**ISSUES**

**Adjusted Gross Income Tax and Supplemental Net Income Tax – Unrelated Business Income**

**Authority:** IC 35-45-5-3; IC 6-2.5-5-25; IC 6-2.1-3-23; IC 6-3-2-3.1(a); IC 6-3-1-17(a); 45 IAC 3.1-1-68.

The taxpayer protests the imposition of adjusted gross and supplemental net income tax on proceeds from illegal gambling machines and pull tab sales.

**Tax Administration – Penalty**

**Authority:** IC 6-8.1-10-2.1; 45 IAC 15-11-1 & 2

The taxpayer protests the Department's imposition of the ten percent (10%) negligence penalty.

**STATEMENT OF FACTS**

As a result of an income tax audit conducted by the Department of Revenue, illegal gambling machines were discovered at the taxpayer's location. The taxpayer was also selling pull tabs illegally. Neither the taxpayer nor its representative appeared for the hearing. This Letter of Findings is written based upon the information contained in taxpayer's file.

**Adjusted Gross and SNIT – Unrelated Business Income**

## **DISCUSSION**

Under Indiana Code section 35-45-5-3 the machines operated in taxpayer's establishment constitute illegal gambling. Proceeds from illegal gambling are considered unrelated business income and subject to Indiana gross or adjusted gross and supplemental net income tax. Indiana State Police estimate that the amount of gross income from illegal gambling machines is approximately \$104,000 per year for a single machine. The taxpayer was also selling pull tabs without a license from the Department of Revenue.

In its protest letter, the taxpayer argues that it did not have any machines on the premises in 1997. In 1998, the taxpayer states that they had five (5) machines from January through October of that year. The taxpayer then states that it acquired an additional five (5) machines from October through December of 1998. The taxpayer also provided that Department with records starting in 1999 which allegedly shows the average monthly revenue of thirty thousand dollars (\$30,000) for all ten machines. The taxpayer also maintains that the pay out on the machines was eighty percent (80%).

First, the taxpayer contends that the machines are not illegal and are used primarily in raising money for charitable purposes. The taxpayer also contends that the money raised from the machines helped support their charitable purpose and was also used to supplement their operation. However, using any of the money from the illegal machines cannot in any way be characterized as a charitable purpose. Second, taxpayer protests the imposition of gross, adjusted gross, and supplemental net income tax on proceeds from the machines. Third, the taxpayer states that the amount of money attributable to the machines was significantly less according to their records.

IC 35-45-5-3 provides in pertinent part:

A person who knowingly or intentionally: ... (3) maintains, in a place accessible to the public slot machines, one-ball machines or variants thereof... commits professional gambling, a Class D felony.

The Department determined that illegal gambling by the taxpayer was unrelated to taxpayer's exempt purpose. Exemption from tax for exempt organizations is tied to the gross income tax provisions with respect to exempt organizations. IC 6-2.5-5-25. As provided under IC 6-2.1-3-23, exempt organizations are not entitled to exemption from gross income received by a taxpayer that is derived from an unrelated trade or business, as defined in Section 513 of the Internal Revenue Code. Thus, the Department's determination was guided by I.R.C. § 513, which provides, in part, the following:

...The term "unrelated trade or business" means, in the case of any organization subject to the tax imposed by section 511, any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501.

Pursuant to IC 6-3-2-3.1(a) and IC 6-3-1-17(a), the Indiana General Assembly has expressly adopted the Code's tax treatment, with respect to Code section 501(c) organizations, for purposes of the Indiana adjusted gross and supplemental income tax analysis. Moreover, the Department's rule 45 IAC 3.1-1-68 defines an unrelated trade or business under the same guidelines as IRC section 513, and the rule also subjects any unrelated business income to the Indiana taxes. Additionally, the rule cites taxpayers to Code sections 511 through 515 for guidance in determining whether income is subject to the taxes.

### **FINDING**

The taxpayer's protest is denied.

## **II. Tax Administration - Liability for 10% Negligence Penalty**

### **DISCUSSION**

The taxpayer protests the Department's imposition of the ten percent (10%) penalty assessment. Indiana Code section 6-8.1-10-2.1 requires a ten percent (10%) penalty to be imposed if the tax deficiency is due to the negligence of the taxpayer. Department regulation 45 IAC 15-11-2 provides guidance in determining if the taxpayer was negligent. 45 IAC 15-11-1(b) defines negligence as "the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer." Negligence is also to be determined on a case-by-case basis according to the facts and circumstances of each taxpayer.

Subsection (d) of IC 6-8.1-10-2.1 allows the penalty to be waived upon a showing that the failure to pay the deficiency was due to reasonable cause. Departmental regulation 45 IAC 15-11-2(c) requires that in order to establish reasonable cause, the taxpayer must show that it "exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed. . . ."

In this instance, the taxpayer has not shown reasonable cause. The taxpayer has not provided to the Department's satisfaction, sufficient justification for interpreting the code as it did.

### **FINDING**

The taxpayer's protest is denied.

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